Supreme Court, U. S.
FILED
MAY 6 1977
MICHAEL RODAK, JR., CLERK

No. 76-1137

In the Supreme Court of the United States

OCTOBER TERM, 1976

ARTHUR FULMAN, ET AL., TRUSTEES, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

MEMORANDUM FOR THE UNITED STATES

WADE H. McCREE, JR.,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

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The petition in this federal income tax case seeks resolution of a question with respect to which there is a conflict in the circuits concerning the computation of the deficiency dividends deduction under the personal holding company tax imposed by Section 541 of the Internal Revenue Code of 1954, as amended (26 U.S.C.). The question presented is whether a personal holding company's distribution of appreciated property to its shareholders results in a deduction from undistributed personal holding company income in an amount equal to the corporation's adjusted basis in the distributed property, as the court of appeals held, or the fair market value of the property at the time of the distribution, as petitioners contend.

Petitioners are the successors to, and transferees of assets of, Pierce Investment Company (Pierce). On audit, the

Commissioner of Internal Revenue concluded that Pierce was a personal holding company, as defined in Section 542(a) of the Code, for the years 1959, 1960, 1962, and 1963, and determined deficiencies in personal holding company taxes of $26,571.30 (Pet. App. A, pp. 9-10; R. 20-21).[1]

Pursuant to the deficiency dividend procedures provided by Section 547 of the Code, Pierce agreed to the Commissioner's determination of its personal holding company tax liability and, within 90 days after executing the agreement, distributed to its shareholders appreciated stock that it held in other companies. The stock had a fair market value of $32,535 at the time of distribution; its adjusted basis in Pierce's hands was $18,725.11. Pierce then filed a claim under Section 547 of the Code for a deficiency dividends deduction of $32,535 (Pet. App. A, pp. 9-10; R. 21).

Pursuant to Treasury Regulations, Section 1.562-1 (a) (26 C.F.R.), the Commissioner disallowed the claimed deduction to the extent that it exceeded Pierce's adjusted basis in the distributed stock and assessed a tax on the remaining undistributed personal holding company income (Pet. App. A, p. 10).

In this refund suit brought by Pierce in the United States District Court for the District of Massachusetts, the district court upheld the validity of the governing Treasury Regulations and concluded that Pierce's dividends paid deduction was limited to its adjusted basis in the distributed stock (Pet. App. B, pp. 18-24).[2] The court of appeals affirmed (Pet. App. A, pp. 8-17).

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[1]"R." refers to the record appendix filed in the court of appeals.

[2]Pierce was dissolved while this action was pending before the district court and petitioners were substituted as the plaintiffs.

holding that by limiting the dividends paid deduction to the adjusted basis of the distributed stock, the Regulations were consistent with the objective of the personal holding company tax to impose a penalty on a corporation's realized undistributed passive income.

1. The marginal tax rate applicable to corporations is substantially lower than that applicable to individuals. In the absence of a statutory corrective, the differential between corporate and individual tax rates would permit high-bracket individual taxpayers to transfer passive investment property to closely held corporations, accumulate the income, and then sell or liquidate the corporations at capital gains rates, thereby achieving a lower net tax than if they had held the property outright.

Since 1934, the personal holding company tax has supplied the necessary corrective. Generally speaking, it is a special tax, imposed in addition to the ordinary income tax, on the income from passive investments that has been accumulated by a "personal holding company," which is defined by Section 542(a) of the Code as a corporation more than 50 percent of whose stock is owned, actually or constructively, by five or fewer individuals. The tax is imposed if at least 60 percent of a personal holding company's adjusted ordinary gross income for the year is "personal holding company income," which Section 543 defines primarily as passive investment income such as dividends, rents, and interest. When it applies, the personal holding company tax is 70 percent of the corporation's undistributed personal holding company income.

Once the Commissioner determines that a corporation is liable for the personal holding company tax, however, the corporation may avoid the tax by distributing its personal holding company income to its shareholders; such

distributions give rise to a "dividends paid deduction" that reduces the amount of undistributed personal holding company income to which the tax applies. See Sections 541, 545, and 561 of the Code. Thus the personal holding company tax is an inducement to the distribution of realized passive investment income to shareholders in the form of taxable dividends. See Libin, *Personal Holding Companies and the Revenue Act of 1964*, 63 Mich. L. Rev. 421, 422-424 (1965).

The question presented in this case concerns the computation of the dividends paid deduction when a personal holding company distributes appreciated property rather than cash to its shareholders. Petitioners claim a dividends paid deduction equal to the fair market value of the appreciated property that was distributed to shareholders after determination of liability for the personal holding company tax. The government's position, which is set forth at Treasury Regulations, Section 1.562-1 (a) (see Appendix, *infra*, pp. 1a-2a), and was sustained by the courts below, is that the dividends paid deduction with respect to in-kind distributions is limited to the distributing corporation's adjusted basis in the property.

2. The limitation on the dividends paid deduction provided by Section 1.562-1(a) of the Regulations is both reasonable and consistent with the statutory scheme. The personal holding company tax is intended to prevent the tax avoidance that would result if realized investment income that would otherwise be taxable at progressive rates applicable to individuals could be accumulated at the corporate level. The net effect of the tax is to induce personal holding companies to distribute all of their passive investment income to the shareholders, or risk imposition of the penalty tax. But if a corporation

could distribute appreciated property to its shareholders and claim a dividends paid deduction equal to the fair market value of the property, it could retain part of its passive investment income and nevertheless avoid the personal holding company tax on such income. Section 1.562-1(a) of the Regulations therefore provides that the dividends paid deduction is limited to the corporation's basis in distributed property, *i.e.*, the amount of corporate earnings actually invested in the distributed property. Since the Regulation is consistent with the objectives of the personal holding company tax, the court of appeals correctly upheld its validity. See, *e.g.*, *Bingler* v. *Johnson*, 394 U.S. 741; *Commissioner* v. *South Texas Co.*, 333 U.S. 496.

Petitioners contend that personal holding companies should be entitled to a dividends paid deduction equal to the fair market value of property distributed in kind at the time of the distribution. But petitioners' market value rule would permit personal holding companies to accumulate passive investment income and shelter it from the personal holding company tax by distributing appreciated property to its shareholders. Moreover, as the court of appeals pointed out (Pet. App. A, pp. 16-17), acceptance of petitioners' argument would lead to disparate treatment of personal holding companies that had equal amounts of personal holding company income but invested their income in property that appreciated at different rates.

Finally, as the court of appeals observed (Pet. App. A, pp. 11-14), the pertinent legislative history supports the validity of the Commissioner's Regulation providing that the amount of the dividend paid deduction is equal to the adjusted basis of the distributed property. Section 27(d) of the Internal Revenue Code of 1939 (26 U.S.C. (1952 ed.)) expressly provided that the amount of a deduction for dividends paid in kind was either the corporations's adjusted

basis in the property or the fair market value, whichever was less. While Congress did not include Section 27(d) in the 1954 Code, the Senate Finance Committee Report with respect to Section 562(a) indicates that the rule of Section 27(d) was to be carried over into the 1954 revision. Thus, the Committee Report stated that "The requirements of sections 27(d) * * * of existing law are contained in the definition of 'dividend' in section 312, and accordingly are not restated in section 562." S. Rep. No. 1622, 83d Cong., 2d Sess. 325 (1954). The legislature history therefore suggests that Congress did not intend to abrogate the adjusted basis rule of Section 27(d) of the 1939 Code.

3. We agree with petitioners that the decision below conflicts with *H. Wetter Manufacturing Co.* v. *United States*, 458 F. 2d 1033 (C.A. 6). There, as here, a personal holding company distributed appreciated securities to its shareholders. The court held that the corporation was entitled to a Section 562 dividends paid deduction equal to the fair market value of the securities on the date of distribution. In so holding, the Sixth Circuit concluded that Section 1.562-1(a) of the Regulations was invalid. Accord: *Gulf Inland Corp.* v. *United States*, No. 74-157, decided July 16, 1975 (W.D. La.) (75-2 U.S.T.C. Para. 9620), appeal pending, No. 75-3767 (C.A. 5), argued April 19, 1977.[3]

The question of the proper computation of the dividends paid deduction involved in this case is pertinent to other provisions of the Internal Revenue Code in addition to the

[3]Recently, in *C. Blake McDowell, Inc.* v. *Commissioner*, 67 T.C. No. 87 (decided March 30, 1977), a majority of the Tax Court expressed the view that Treasury Regulations, Section 1.562-1(a), was valid, but held for the taxpayer under the Tax Court's *Golsen* rule because an appeal would lie to the Sixth Circuit where *Wetter* would be controlling. See *Golsen* v. *Commissioner*, 54 T.C. 742, 756-758, affirmed on the substantive issue, 445 F. 2d 985 (C.A. 10), certiorari denied, 404 U.S. 940.

personal holding company tax. As petitioners note (Pet. 5), the dividends paid deduction is applicable to the accumulated earnings tax (see Section 535(a)). But it also applies to the foreign personal holding company tax (see Section 556(a)), and the provisions governing regulated investment companies and real estate investment trusts (see Sections 852(b), 857(b)).

We are advised by the Internal Revenue Service that there are 12 personal holding company cases and three accumulated earnings tax cases presently pending with $375,000 and $316,000, respectively, at stake. In addition to the cases presented to three different circuits in the last five years, the Service advises that within the last two years, nine personal holding company tax cases and one accumulated earnings tax case presenting the question were closed administratively. Those cases involved a total of $743,000. Thus, while the issue does not appear to have substantial administrative importance at the present time in terms of the revenue, the question arises with some frequency and the Commissioner and the tax bar should have the benefit of a uniform national rule. We therefore do not oppose the granting of the petition for a writ of certiorari.

Respectfully submitted.

WADE H. MCCREE, JR.,
Solicitor General.

MAY 1977.

DOJ-1977-05

APPENDIX

Treasury Regulations on Income Tax (26 C.F.R.):

§1.562-1 *Dividends for which the dividends paid deduction is allowable.*

(a) *General rule.* Except as otherwise provided in section 562(b) and (d), the term "dividend", for purposes of determining dividends eligible for the dividends paid deduction, refers only to a dividend described in section 316 (relating to definition of dividends for purposes of corporate distributions). No distribution, however, which is preferential within the meaning of section 562(c) and § 1.562-2 shall be eligible for the dividends paid deduction. Moreover, when computing the dividends paid deduction with respect to a U.S. person (as defined in section 957(d)), no distribution which is excluded from the gross income of a foreign corporation under section 959(b) with respect to such person or from gross income of such person under section 959(a) shall be eligible for such deduction. Further, for purposes of the dividends paid deduction, the term "dividend" does not include a distribution in liquidation unless the distribution is treated as a dividend under section 316(b)(2) and paragraph (b)(2) of § 1.316-1, or under section 333(e)(1) and paragraph (c) of § 1.333-4 or paragraph (c)(2), (d)(1)(ii), or (d)(2) of § 1.333-5, or qualifies under section 562(b) and paragraph (b) of this section. If a dividend is paid in property (other than money) the amount of the dividends paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the time of the distribution. See paragraph (b)(2) of this section for special rules with respect to liquidating distributions by personal holding companies occurring

during a taxable year of the distributing corporation beginning after December 31, 1963. Also see section 563 for special rules with respect to dividends paid after the close of the taxable year.

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